

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]:GL-808610-99
[REDACTED]

date: OCT 18 1999

to: Chief, Examination Division, [REDACTED]
Attn: [REDACTED]

from: District Counsel, [REDACTED]

subject: [REDACTED]

Docket No. [REDACTED] (USBC [REDACTED])

As you know, on [REDACTED] and [REDACTED] filed Chapter 11 petitions with the [REDACTED] of [REDACTED]¹. The cases are being jointly administered. The Service intends to file a proof of claim in the bankruptcy proceedings. Before the Service files a proof of claim asserting a claim for unassessed corporate income taxes against [REDACTED] in the amount of \$ [REDACTED], we requested that the Service solicit our review of the issues underlying the proposed assessment. You have forwarded your proposed Explanation of Items to counsel for consideration. Because the tax deficiency is primarily attributable to adjustments to the NOL carryback under I.R.C. § 172(f), this issue must be coordinated with the National Office.

We have discussed this case with counsel in Field Service. Counsel has advised us that he concurs with your position that the fees, losses and expenditure incurred in the taxpayer's [REDACTED] bankruptcy proceeding are not allowable under section 172(f). We concur.

FACTS

The Service proposes to file no later than November 1, 1999 a claim totaling \$ [REDACTED] in the [REDACTED] liquidating Chapter 11 case. At this time, it is unlikely that there will ever be a plan proposed or confirmed. The estate is

¹ [REDACTED] had previously filed a Chapter 11 case in that court on [REDACTED].

being liquidated without a plan. It is probable that there will be only de minimis distributions, if any, to creditors other than the prepetition lender.

The Service's claim includes the proposed adjustment totaling \$ [REDACTED]. The Revenue Agent has disallowed the net operating loss carryback of specified liability losses claimed by the taxpayer under section 172(f) on its return for year ended [REDACTED]. The losses had been carried back to years ending [REDACTED], [REDACTED] and [REDACTED].

The taxpayer filed Form 1139 for a tentative refund. Following refunds were paid to

[REDACTED]

year

refund

[REDACTED]

\$ [REDACTED]
\$ [REDACTED]
\$ [REDACTED]

The agent proposes to disallow the tentative refunds in the above amounts. The agent proposes deficiencies in the amounts of \$ [REDACTED], \$ [REDACTED] and \$ [REDACTED] for years [REDACTED], [REDACTED] and [REDACTED] respectively.

The Service has determined that the expenses incurred by [REDACTED] in taxable year ended [REDACTED] cannot be carried back ten years pursuant to I.R.C. § 172(f). The specified liability losses claimed for year [REDACTED] totaled \$ [REDACTED]. Those losses were carried back to year [REDACTED] which triggered the carry back of certain credits to year [REDACTED].

The specified liability losses which were disallowed included:

Bankruptcy costs	
including statutory professional fees	\$ [REDACTED]
and statutory closing costs	\$ [REDACTED]
Workmen's compensation	\$ [REDACTED]
Tax Payments	\$ [REDACTED]
Total 172(f)	\$ [REDACTED]
The NOL for year [REDACTED] totaled	\$ [REDACTED]

The Service has disallowed the entire specified liability loss carryback under section 172(f) because the expenditures do not qualify as specified liability losses. The taxpayer claims that statutory professional fees and statutory closing costs incurred in the [REDACTED] bankruptcy proceeding qualified as 172(f) carrybacks. Those professional fees include legal and accounting costs, salaries and wages, compensation of officers and other "various deductions." The statutory closing costs include lease cancellation fee, officers' compensation, cost of goods sold, losses on Form 4797, salaries and wages and "various deductions."

The taxpayer also claims that workmen's compensation premiums are specified liability losses. Additionally, the taxpayer carried back losses for tax payments under section 172(f). Those tax payments included property taxes, property taxes included in lease payments, FICA taxes, and unemployment taxes.

DISCUSSION

The Service asserts that the taxpayer is not entitled to carryback the foregoing losses relating to the taxpayer's [REDACTED] bankruptcy ten years pursuant to section 172 (f). Section 172(b)(1)(C) provides that a taxpayer can carry back a specified liability loss as defined by section 172(f) for each of the ten taxable years preceding the year of such loss. Section 172(f)² provides, in pertinent part, any amount allowable as a deduction under Chapter 1 with respect to a liability which arises under a Federal or State law if the act or failure to act giving rise to the liability occurs at least three years before the beginning of the taxable year.³ I.R.C. § 172(f)(1)(B). The taxpayer must use the accrual method of accounting. I.R.C. § 172(f)(a)(B). The specified liability loss of any taxable year is limited to the amount of the net operating loss for such year. I.R.C. § 172(f)(2).

In this case the taxpayer was on the accrual method of accounting for year [REDACTED]. The specified liability loss did not

² Applicable for year [REDACTED]. All references herein are to the law applicable for year [REDACTED].

³ The definition of "specified liability loss" was amended effective for net operating losses arising in tax years ending after [REDACTED] to restrict the losses to liability under Federal or state law to reclamation of land, decommissioning of a nuclear power plant, dismantlement of a drilling platform, environmental remediation, or payment under workers compensation acts.

exceed the net operating loss of [REDACTED]. The issues are whether the liability arises under a Federal law and, if so, whether the act or omission giving rise to the liability occurred at least three years before [REDACTED], the beginning of the taxable year.

The losses all were incurred during the bankruptcy proceeding filed by the taxpayer on [REDACTED]. Although we do not have the taxpayer's statement of its position, we understand that the taxpayer contends that liabilities in a bankruptcy action meet the requirement that the liability arises under a Federal law. We do not know what causative "acts" or omissions the taxpayer believes occurred three years prior to [REDACTED]. Obviously, it was not the filing of the petition in bankruptcy.

We do not believe the taxpayer's arguments could have merit because the expenditures do not constitute "liabilities arising under Federal law". In *Sealy Corporation v. Commissioner*, 107 T.C. 177 (1996), the Tax Court held that the petitioner's cost of complying with ERISA and the Internal Revenue Code were not specified liability losses. The court reasoned that provisions requiring taxpayers to file reports, maintain books and records or cooperate with IRS audits did not establish the taxpayer's liability to pay the amount of the cost of that compliance. *Id.* The liability to pay those amounts did not arise until the taxpayer contracted for and received the services. *Id.* It was not the regulatory provisions that determined the nature and cost of compliance. *Id.* Further, if the taxpayer failed to comply with the statutory requirements, the liability would be in amounts not measured by the value of the services. *Id.* The liability in *Sealy* did not arise under Federal law.

Similarly, in this case the compliance with the requirements of the Bankruptcy Code does not establish liability for the cost of services engaged in order to comply with the Bankruptcy Code. The cost of the services and the nature of the services were not dictated by federal law. The taxpayer chose what attorneys to hire and how much to pay them. The taxpayer decided to assign certain employees to tasks tending to accomplish goals which the taxpayer determined would meet the requirements of the Bankruptcy Code. Abandoning the leaseholds was not even required by the Bankruptcy Code. That was the taxpayer's choice of means to comply and the liability was not in any way related to the penalties for failure to comply with the Bankruptcy Code.

The workers compensation costs claimed by the taxpayer were for premiums, not for payments deferred under 461(h).⁴ Thus, we do not believe those costs qualify for the ten year carryback under section 172(f) because the premiums are not the "liability" of the taxpayer requiring a payment to another person.

The court in *Sealy* concluded that the interpretation of section 172(f) which disallowed losses generated by mere compliance with federal ERISA and the Internal Revenue Code was consistent with the legislative history of section 172(f). The provision only applies to accrual basis taxpayers and it was enacted to address the economic performance rule of section 461(h). Section 461(h) defers certain liabilities so that the all events test for the accrual taxpayer is not met until economic performance occurs. The court noted that the legislative history suggested that section 172(f) was intended to permit the carryback of losses attributable to liabilities deferred under 461(h) *Id.*; H. Conf. Rept. 98-861, at 871-873 (1984), 1984-3 C.B. (Vol.2) 1, 125-127. The court concluded that since the economic performance rules did not limit the taxpayer's accrual of the deduction for the compliance expenses in *Sealy*, Congress did not intend those expenses to qualify as specified liability losses. Here the economic performance rule does not limit the accrual of the deduction for compliance with the Bankruptcy Code. In fact, under the amendment to Section 172(f) effective for losses arising in years beginning after October 22, 1998, the specified liability losses are limited to those arising under specified federal laws which are impacted by the economic performance rule of 461(h). There was no deferral of the losses at issue in this case under the economic performance rule. Therefore, the losses do not come within 172(f).

The court in *Sealy* also decided that the specified liability losses in section 172(f) were limited to a relatively narrow class of liabilities similar to the others identified in the statutory enumeration. Nothing in the statute, such as tort losses, product liability or nuclear decommissioning were in any way similar to the expenses incurred by the bankrupt taxpayer in complying with the Bankruptcy Code.

Further, the taxpayer has provided no evidence that the acts or omissions giving rise to the expenses occurred more than three years prior to [REDACTED]. The bankruptcy petition

⁴ Section 461(h) provides that if the liability of the taxpayer requires a payment to another person and it arises under any workers compensation act, economic performance occurs as the payments to such person are made.

commencing the case which necessitated the expenditures at issue was in [REDACTED]. Until that time, there could be no liability even related to the bankruptcy laws.

CONCLUSION

We conclude that the taxpayer is not entitled to carryback any losses arising from expenditures in the Chapter 11 bankruptcy because those losses are not specified liability losses under section 172(f).

[REDACTED]
District Counsel

By:

[REDACTED]
Attorney//